Exhibit C

naked capitalism

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Monday, June 23, 2008

More on "How Did Lehman Delever?"

Readers may recall that last we ran a post last week on Lehman's 2Q earnings announcement, its conference call, and some questions raised by an e-mail from a former Lehman managing director.

To recap: the investment bank reported a gross asset reduction of $147 billion, net of $70 billion (we consider the $70 billion the more significant number, since the balance of the assets were probably subject to agreements to repurchase and thus quite liquid). These reductions were consistently characterized as sales in the conference call. But just as some animals are more equal than others, "sale" can cover a multitude of sins.

Indeed, the ex-Lehman staffer indicated that some assets were sold to parties in which Lehman has an economic interest, newly-formed funds headed by ex-Lehman employees called R3 and One William Street. We indicated that since this information came from a single source, it had to be regarded as a rumor, although it was unusually specific as to details.

Later in the week, a Bloomberg story substantially confirmed the information the source provided about a fund started by the former head of Lehman's principal strategies group, R3 Capital Partners, particularly that the Lehman did have a stake in the firm and would benefit if the $5 billion of assets sold to the fund appreciated. While this Bloomberg story reported that a very small amount of Lehman assets was sold to One William Street, it, did not indicate whether the investment bank had an ownership stake in that fund. However, an earlier Bloomberg story said that Lehman was expected to back the fund (and perhaps more telling, "One William Street" is the address of the former Lehman headquarters building and has been used in the past as a name for in-house funds. One would imagine that the firm would not permit it to be used casually).

The ex-insider has written to us again to clarify what he initially heard about R3 (we'll return to that

later; he said that several Lehman employees have since told him that a memo circulated internally said, just as the Bloomberg article did, that $5 billion was sold to R3 Capital Partners).

He also passed along another bit of information which he maintains came from "several people who are in a position to know." Again, however, since I cannot verify this independently, this too must be regarded as a rumor:

> LEH is allowing employees of both of these new funds to continue vesting any LEH restricted stock they held when they left. This is extraordinarily generous, and unusual to say the least. Lehman, like most of the brokers, provides 1/3-1/2 of employees' bonuses in restricted stock that vests after either 3, 4 or 5 years (depending on seniority, size of grant, etc). Ordinarily, when you leave the firm, all unvested stock is forfeited. The expense, to Lehman, of doing this is surely well into nine figures…perhaps quite well into nine figures. Seems an expensive & unnecessary gesture, given that all the employees are now happily ensconced in major hedge funds, and one that LEH can, at the moment, ill-afford.
>
> There aren't many reasons to provide deferred comp to people who are not longer your employees. In fact, the only good reason to do so is to ensure the former employees' continued good will, and to have something to hold over them in case they engage in an activity you consider detrimental. It's hard to think of any detrimental activity that these fine folks might engage in (from LEH's perspective)…at least, no activity that'd be worth hundreds of millions of dollars of scarce shareholder capital…other than making public details of the arrangements between LEH & the start-ups which LEH might find quite inconvenient to have generally known.

Let me stress that the second paragraph, after the first sentence, is speculation by this former employee. However, I struggle to find a good business rationale for a move like this, assuming the details are accurate, particularly given the magnitude of the costs alleged.

We has noted in our earlier post that pay stood out as an anomaly. Employee compensation rose $418 million in the second quarter, with only $130 million of that severance, when headcount fell by 1,900. To put that in context: *the non-severance component of the pay increase equalled 10% of Lehman's quarterly loss*. That begs for explanation.

The severance figure also looks high. I may be woefully out of date, and those more current can correct me, but my understanding is severance is not a common perk on Wall Street. I believe in some countries with tough labor laws, there are minimums based on years of service. Another group that would be eligible were those who had employment contracts; the cost of early termination would be classified as severance. Having said said that, each firm is free to have its own policies, and Lehman's may simply have been unusually generous. However, $130 million divided by the 1,900 employees dismissed is $68,000 per employee. Any reader input here would be appreciated.

Now some readers may think we are going too harshly after Lehman. Let us stress that in the year and a half this blog has been up, this is only the second source whose information we thought was worth advancing even though we could not independently corroborate it.

In this case, the reason we chose to do so is that while Lehman was extremely forthcoming in *what* assets it had sold, it was virtually silent as to *how* it sold them. And "how" is a legitimate question in these difficult credit markets.

In turbulent markets, when firms need to trim their exposures, they try to sell what they can without showing a loss (or much of a loss). Even with positions marked down, a price that is a fair mark for a transaction of $10 million is not what a dealer would realize if trying to unload $500 million in a troubled market with spotty demand. Proof of that conundrum already exists. Investment banks have financed sales of leveraged loan and Alt-A portfolios to avoid realizing further losses. Similarly, a bank took a 25% loss in May on the sale of a $3 billion Alt-A portfolio that it had maintained in an early March regulator filing was impaired by at most 10% using a stress test scenario. Note it had hired an investment bank to market the position, so it clearly could have been sold in smaller pieces had than been more attractive.

Moreover, some of Lehman's valuations had already come under question (see here, for instance, which includes a discussion of commercial mortgage marks). Having a mark that was, shall we say, generous, would be an impediment to selling an asset, since a disposition would produce a loss.

That's a long-winded way of indicating that financial firms under stress typically wind up selling their most saleable assets, which makes them more liquid, but often winds up lowering the quality of their remaining holdings.

Yet Lehman seems to have achieved the miraculous, unloading $70 billion of assets, and the only mention of an assist in the conference call was:

> The approximately 8 billion of commercial mortgage and real estate held-for-sale assets sold this quarter were across the capital structure to over 170 different client accounts and approximately 80% were outright sales without seller financing.

Note that $8 billion was the only place where I saw the number and nature of end buyers mentioned.

Aside from the mention that "other nonmortgage asset backed exposures… were flat at 6.5 billion this quarter," the sales were broadly spread across asset types, and as Lehman stressed, "We sold a variety of assets and not just the most liquid….the sales were across sort of, all asset classes, across all the types….They were spread over the whole quarter." The last is a particularly remarkable achievement, given how disrupted the markets were in March, the month of the Bear meltdown.

So if, as with R3, the firm has an economic interest in the assets sold and an ownership stake in the buyer, that begs the question of whether there is residual risk. As we saw with SIVs, assets were placed in entities that had been thought could be allowed to sink or swim. Yet in most cases, when things went pear-shaped, the sponsoring bank stepped forward to assume control, deeming the potential damage to its reputation and relationships to be too great. Thus while Lehman no doubt structured this relationship so that the asset transfer can be called a sale from an accounting standpoint, the use of that term seems questionable from a common-sense perspective.

So how did the source get one bit of his original information so wrong, namely, that the amount Lehman sold to R3 Capital Partners was $5 billion, when he said the amount R3 acquired was $55 billion? His comment:

> The $55 billion figure came from a source directly involved with R3. To be completely fair, the figure related to R3's entire asset base at its launch (as in, "R3 is spinning out of Lehman, and is launching with $55 billion in assets."). I don't recall being told specifically that 100% of the assets came from Lehman…that part was my inference, given that R3 was just starting life as an independent entity.

This illustrates why one has to treat information that cannot readily be verified with caution. But having said that, $55 billion is a very large number for a fund to have at its birth. The number is consistent with the acquisition of a portfolio or several portfolios.

Then again, the person who spoke to the former employee could simply have been wrong….

More on this topic (What's this?)

Advanced Distressed Debt Lesson - Double Dip (Distressed Debt Investing, 8/9/10)

Is Lehman Brothers Next? (Contrarian Profits, 3/18/08)

Och Ziff Refuses To Cooperate With Investigation Into Whether It Sunk Lehman (Phil's Stock World - Members S..., 8/12/10)

Read more on **Lehman Brothers** at **Wikinvest**

Topics: Investment banks

Email This Post Posted by Yves Smith at 2:00 am

23 Comments » Links to this post

BOOKMARK

23 Comments:

- *Steve* says:

June 23, 2008 at 2:50 am

If in fact Lehman is significantly understating its exposures (and that's only a hypothesis), then we can pretty much assume that their liquidity provider (the Fed) and their narcoleptic regulator (the SEC) are complicit, which boosts the odds of *uncontrollable* systemic effects if anything fishy does turn up.

- *Ginger Yellow* says:

June 23, 2008 at 4:19 am

The severance figure doesn't seem particularly high to me, but you're right that it would be very interesting to know what's up with the rest of the $418m. You can't imagine that bonuses went up this year.

- *Yves Smith* says:

June 23, 2008 at 4:27 am

Ginger,

Keep in mind that the usual Wall Street pattern is to first get rid of the VP types, who are comparatively costly but not yet revenue generators, and proportional cuts in secretarial staff. MD cuts tend to be limited to those who are out of favor and/or in areas that look terminal.

Next to go are slightly more and less senior. In my day, VPs would not have been entitled to severance, but again, things may have changed, and I have no idea re support staff.

- *Ginger Yellow* says:
June 23, 2008 at 7:55 am

"Keep in mind that the usual Wall Street pattern is to first get rid of the VP types, who are comparatively costly but not yet revenue generators, and proportional cuts in secretarial staff. MD cuts tend to be limited to those who are out of favor and/or in areas that look terminal. "

That hasn't been the pattern this time, at least not in structured finance. Apart from where entire teams have got the chop (which is itself pretty widespread), the MDs have been the first to go. I know plenty of SF teams where everybody above VP has been sacked. I think the banks figure that they can get rid of a large wage bill quickly, and if the market recovers, they can pick up one of the hundreds of experienced MDs on the market cheaply.

- *eh* says:
June 23, 2008 at 8:03 am

I believe in some countries with tough labor laws, there are minimums based on years of service.

Not sure about any prescribed minimum. More likely are laws requiring an agreement with representatives of the employees (whose existence, responsibilities, and powers may be spelled out in laws) who will be affected by downsizing. Usually there is some sort of precedent to go by, either at the same company or outside, and in any case the employer is likely to agree to something more or less acceptable (even generous) in order to get on with things quickly.

- *jm* says:
June 23, 2008 at 9:13 am

It would seem that for former Lehman employees to continue vesting Lehman restricted stock grants in their new jobs would in many cases set up a conflict of interest.

- *Anonymous* says:
June 23, 2008 at 10:00 am

I don't have any problem with Lehman paying severance…that seems fairly normal (esp'lly for sr employees). But it is odd that they are not paying it as a lump sum. You'd think they'd want to take advantage of the large writedowns in May to "kitchen sink" the separation payments, instead of continuing to accrue over several years. Very odd.

- *Yves Smith* says:
June 23, 2008 at 10:32 am

Ginger,

I did see a recent article (Breaking Views, perhaps) which mentioned the VP phenomenon for those not familiar with it. I'll see if I can track that down. The post said, "MD cuts tend to be limited…..to areas that look terminal." Structured finance would fit that bill.

Anon of 11:00 AM,

I'm mot objecting to severance, merely questioning if the level at Lehman looks normal. Good point re kitchen sink.

Jim,

Thanks for the input.

- *stock market blog* says:
June 23, 2008 at 11:22 am

Saudi Arabia has already boosted its production by 300,000 barrels a day, or about 3 percent, to 9.45 million barrels a day last month. But that has had little impact on soaring prices. Oil futures in New York have gained more than 40 percent this year. They rose 2 percent to $134.62 a barrel before the meeting on Friday.

very interesting: Will the market implode or rally??
http://www.wallstreetjournal.com/story/market_implode_or_rally?

- *Anonymous* says:
June 23, 2008 at 11:34 am

These guys love Cayman Islands and they probably have opened some entity in the islands somewhere to at as a conduit. This is a story for IRS and tax evasion IMHO!

Enron was fairly good at this game and I'm sure these guys know how to play pirate games!

- *doc holiday PI* says:
June 23, 2008 at 11:40 am

Lehman Risk Services (Bermuda) Ltd. Bermuda

Opal Finance Holdings Ireland Limited Ireland

CIMT Limited Cayman Islands
TMIC Limited Cayman Islands
MICT Limited Cayman Islands
Falcon Investor I-X Inc. Cayman Islands

Revival Holdings Limited Cayman Islands

Falcon Investor I-X Inc. Cayman Islands

LB Delta Funding Cayman Islands
LB Delta (Cayman) No 1 Ltd. Cayman Islands
LBHK Funding (Cayman) No. 4 Ltd. Cayman Islands
LB Asia Issuance Company Ltd. Cayman Islands
LBHK Funding (Cayman) No. 1 Ltd. Cayman Island

Cohort Investments Limited Cayman Islands

Crooks are always retarded!

- *doc holiday* says:

June 23, 2008 at 12:12 pm

Weird stuff related to: LB Alpha Finance Cayman Limited

http://sec.edgar-online.com/2008/01/29/0001104659-08-005476/Section60.asp
EXHIBIT 21.01
LIST OF THE REGISTRANT'S SUBSIDIARIES
as of November 30, 2007

I pulled up Lehman's LB Alpha Finance Cayman Limited as an example of an offshore coduit and came across this odd old connection between ASB & Silver Fern, which is a New Zealand mortgage lender, which ASB refers to in the report below. I'm curious as to why LB Alpha Finance Cayman Limited is mentioned by both Lehman & ABS … hmmmm?

ASB is one of New Zealand's largest banks, with branches throughout the country. It also has insurance and securities arms.

http://home.nzcity.co.nz/finance/personal/default.aspx?i=mortgages

http://asianbanks.net/HTML/Files/NZ/ASB%20Annual%202003.pdf

For the year ended 30 June 2003

… the Bank has increased its overall market share, both nationally and in the important Auckland market, advancing $6 billion in home loans. The vibrant housing market had a material impact on the levels of lending achieved, andthe personal banking division and associated ASB home lending brands increased assets by 18% to $16.0 billion.

All subsidiaries were incorporated in New Zealand except for LB Alpha Finance Cayman Limited, SilverFern Investments Limited and Waterloo & Victoria Limited which were incorporated in the Cayman Islands.Shares owned in LB Alpha Finance Cayman Limited and SilverFern Investments Limited carry 75% and 70% of the voting rights in the respective companies

6. Investments in Associates and Subsidiaries continued LB Alpha Finance Cayman Limited and SilverFern Investments Limited are consolidated as subsidiaries as the Banking Group has the ability to obtain a significant level of ownership benefits from its investment in these companies.The consolidated financial statements also include the controlled entity Lighthouse Trust as an in-substance subsidiary. Lighthouse Trust has a balance date of 31 December.The Companies Office has given exemptions for

LB Alpha Finance Cayman Limited and SilverFern Investments Limited to maintainbalance dates different to that of the Bank. The application for exemption in relation to Whitcomb Company has been made.

- *doc holiday* says:

June 23, 2008 at 12:17 pm

Re: Shares owned in LB Alpha Finance Cayman Limited and SilverFern Investments Limited carry 75% and 70% of the voting rights in the respective companies

The Commonwealth Bank is now the second largest Australian listed company on the Australian Securities Exchange as of January 2008 with brands including Colonial First State Investments Limited, ASB Bank (New Zealand), Commonwealth Securities Limited (CommSec)and Commonwealth Insurance Limited (CommInsure).

- *doc holiday* says:

June 23, 2008 at 12:23 pm

1. In 1989 The Commonwealth Bank acquired 75% of ASB Bank in New Zealand.

2. Shares owned in LB Alpha Finance Cayman Limited and SilverFern Investments Limited carry 75% and 70% of the voting rights in the respective companies

3. Yah gotta love the fact that Lehman seems to have mis-placed some cash:

In interviews with Fortune, Miscik (pronounced MISS-ik) and her colleagues describe her improbable journey from Washington to Wall Street, where Lehman deploys her in the financial world not only for her steely intellect but also for her cachet as a former spy. At this year's Black Diamond Executive Conference in Beaver Creek, Colo., the firm's annual gathering for about 100 key clients, they booked her as a main speaker along with Alan Greenspan and Colin Powell.
http://money.cnn.com/magazines/fortune/fortune_archive/2007/07/23/100134938/index.htm

Want more?

- *Anonymous* says:

June 23, 2008 at 12:31 pm

Not sure if my previous comment is still in the ether, or been bounced…but the gist was my opinion that since Rick Rieder and Dave Sherr had their hands on just about every major mortgage transaction Lehman handled over the past several years…if not at the structuring phase then in the secondary market (Sherr) or in repackaging it as a CDO (Rieder), they know everything.

Whoever is left at Lehman clearly wants them close by in case the board, regulators, unhappy investors (and their lawyers), or others, come calling, wanting to know the decision process and who was responsible for some of the more gargantuan losses and more tawdry deals. This includes the commitment and structured finance committees, the risk and legal groups, as well as senior business managers from both sides of the fence (banking and proprietary trading). Cannot blame them for their

concern in this regard but as a shareholder, I wish that more thought had gone into these deals and perhaps some vig foregone at the outset rather than being used this way… . The funding of these vehicles and any sale of Tier 3 assets to them is just waaaay too creative to ignore, and why would shareholders who have been given the runaround before even want to?

- *Anonymous* says:
June 23, 2008 at 12:34 pm

Yves, didn't some one sling mud at you a few weeks ago??

Re: "By pushing the company's aggressive investment strategy, he helped make Enron the biggest wholesaler of gas and electricity, with $27 billion traded in a quarter. The firm's figures, however, had to be accepted at face value. Under Skilling, Enron adopted mark to market accounting, in which anticipated future profits from any deal were tabulated as if real today. Thus, Enron could record gains from what over time might turn out losses, as the company's fiscal health became secondary to manipulating its stock price on Wall Street during the Tech boom. But when a company's success is measured by agreeable financial statements emerging from a black box, a term Skilling himself admitted, actual balance sheets prove inconvenient. Indeed, Enron's unscrupulous actions were often gambles to keep the deception going and so push up the stock price, which was posted daily in the company elevator. An advancing number meant a continued infusion of investor capital on which debt-ridden Enron in large part subsisted. Its fall would collapse the house of cards. Under pressure to maintain the illusion, Skilling verbally attacked Wall Street Analyst Richard Grubman[3], who questioned Enron's unusual accounting practice during a recorded conference call. When Grubman complained that Enron was the only company that could not release a balance sheet along with its earnings statements, Skilling replied "Well, thank you very much, we appreciate that . . . asshole." "

- *Mara* says:
June 23, 2008 at 1:37 pm

Bravo to all the good detective work by the other posters showing the offshore shenanigans. As for the IRS being alerted to this, they themselves are a trust based in Puerto Rico, not fully subject to US laws. I think the banks are merely following a good example.

- *Anonymous* says:
June 23, 2008 at 2:24 pm

R3 is Lehman's internal Compliance restriction code that covers Lehman's own shares. Anybody else find that odd?

- *doc holiday (IRS Bounty Hunter)* says:
June 23, 2008 at 3:01 pm

ASB Bank Limited Annual Report 2002

asianbanks.net/HTML/Files/NZ/ASB%20Annual%202002.pdf

The companies and subsidiaries under which we provide our customers with the range of products and services they need to achieve their financial goals are collectively known as ASB Group.

SilverFern Investments Limited is included as an in-substance subsidiary as the 25% shareholding represents 70% of the voting rights.
The day-to-day management of SilverFern Investments Limited and LB Alpha Finance (Cayman) Limited is provided by external parties.
The Companies Office has given exemptions for L B Alpha Finance (Cayman) Limited and SilverFern Investments Limited to maintain balance
dates different to that of The Bank.

Bastards, I love hunting under rocks for these snakes, but they have so many little holes to crawl in and then spawn. The good news is, they always, without fail screw up and pop up retarded heads as if the coast is clear!

- *doc holiday* says:

June 23, 2008 at 3:06 pm

ASB General Disclosure
Statement
ANNUAL REPORT 2007

reports.asb.co.nz/tp/download/89163/fcd41708c1434361f0f3f6f619b9f2de/ASB-Jun-07.pdf –

Basis of Consolidation
Subsidiaries
Subsidiaries are those entities controlled by the Bank. Control exists when the Bank has the power, directly or indirectly, to govern
the financial and operating policies of entities so as to obtain benefits from its activities. The financial statements of subsidiaries are
included in the consolidated financial statements from the date on which control is transferred to the Bank until the date that control
ceases.
Assets, liabilities and results of subsidiaries are included in the consolidated financial statements on the basis of financial
statements made up to balance date, using the purchase method. All intra-group balances and transactions have been eliminated in
preparing the consolidated financial statements.
Associates
Associates are those entities in which the Bank has significant influence, but not control, over the financial and operating policies.
The Bank has representation on the board of directors of all companies classified as Associates. Associates are accounted for under
the equity method of accounting.

- *doc holiday* says:

June 23, 2008 at 3:11 pm

Damn, another empty shell (for now) maybe:

On 1 July 2003, ASB Investments Limited was sold to ASB Group (Life) Limited.
Stockbridge Holdings Limited was incorporated on 14 July 2003 and SR Edinburgh Limited was acquired on 30 July 2003 resulting
in an increase of $400.0m to the net assets of the Banking Group.
The investment in Silver Fern Investments Limited was sold on 19 September 2003 resulting in a decrease of $600.0m to the net
assets of the Banking Group.

- *doc holiday* says:
June 23, 2008 at 3:46 pm

I'd like to apologize to Ms Yves et al for this stupid wild goose chase, but, one does wonder how LEH engineered the book ('s):

Subsidiaries Disposed of
-
LB Alpha Finance Cayman Limited
27 September 2005 $350m $350m -

Nonetheless, deals like this seems to have connections to Floating Rate Notes….

- *doc holiday* says:
June 23, 2008 at 3:50 pm

Sorry to think out loud, but it is funny how ASB Banking Group sold out of LB Alpha Finance Cayman Limited, yet LEH still claims that LB Alpha Finance Cayman Limited is an active sub. I also could not verify the sale or exchanges of Silver Fern by ASB in 2003; there are no records and I really doubt if it matters.

Cheers

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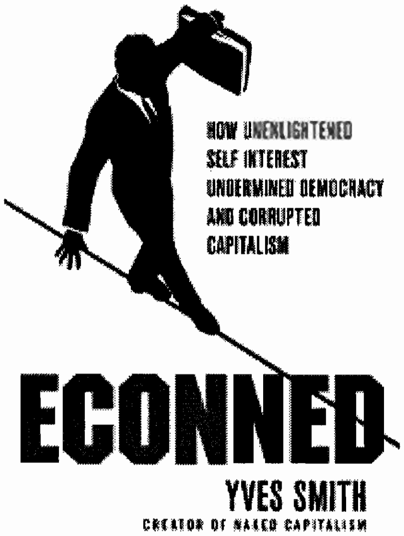

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